MONTHLY REVIEW

April 2023

MAINLINE WEST

New York City Revisit

Munis stumbled through April, slightly underperforming taxables and looking forward to a bullish summer ahead. Demand is estimated to outpace supply by 1.5 times, and the credit quality trend remains strong. The upgrade versus downgrade ratio by S&P for 2023 is at 2.5 to 1 and shows no signs of changing.

In April, MainLine made a much overdue and very informative trip to visit the muni market makers in New York City. After meeting with 15 different players (some old, some new), it appears the sleepy muni market is a changing. How these changes will affect the industry, its investors, and MainLine West and our clients is the focus of this month's credit review.

Muni Market Review

Seasonal technical concerns, with regional bank selling and slightly rich valuations, dragged munis down in April, slightly underperforming taxable fixed income. The Bloomberg composite muni index was down .23% versus US Treasuries Bloomberg composite up .54%. The next three months should be the opposite as maturity/coupon payments are estimated to outpace supply by 1.5 times.

Highlights as follows:

- Muni yields were higher by 16 to 7 bps, as the curve flattened. Taxable yields were mixed -5 bps to + 5 bps, as the curve steepened.
- Supply is still lagging 2022's pace and historical levels and it may not be until fall that it gets going. It is down over 22% year-to-date, 6% versus the five-year average, and not going up anytime soon. Analysts have finally cut their optimistic forecasts.
- Investors are still timid, but returning to munis after a rough 2022. Total flows are up $5 billion; since mid-February there have been weekly outflows totaling $3 billion.

Market News & Credit Update:

- **Biden Tax plan would be a small boost to munis**. The President has proposed in his recent 2024 budget for the top 39.5% tax rate to return one year earlier and increase social security tax to 5% from 3.8% for those earning more than $400,000 a year. These increases would add a little more value to tax-exempt income. There are other tax increases in the plan for corporate, capital gains, and "phantom income". At this point these tax increases appear to be more "sound" than reality.
- The muni market is in the process of digesting over $7 billion of low coupon, long duration, high credit quality bonds being sold, due to the **liquidation of Silicon Valley Bank**. The large and cumbersome process is being led by Black Rock and the market is awaiting the details on how it will be executed. I had the "fortune" to liquidate $12 billion in the summer of 2007 and, if done right, there should be enough cash around to minimize any large market impacts. The bonds will not appeal to everyone, but they should offer value to the right audience.
- After a $4 billion facelift, MainLine had the opportunity to check out the "**new" La Guardia Airport in New York City**. The evolution of the airport from a come and go trip, to a come and hang out, shop, eat and drink is on full display. Airport revenues are no longer solely derived from passenger fees. Although very nice, its runways are still too short for me. It's hard to eat after smelling that airplane tire rubber burning during the landing.

New York City Revisit

Due to COVID and market volatility, it has been five years since MainLine visited the muni market participants in New York City. MainLine needed to get updated on what was happening at the firms, meet with banks regarding the upcoming Fund VIII, and update the street on what was going on at MainLine. We had the opportunity to have 15 meetings in three days and spent quality time with some of the leaders in muni finance, traders, underwriters and analysts, who all play a key role in providing our clients' institutional access.

Things are changing in the sleepy muni market and MainLine came back from NYC ready to adapt to the developments. We thought it would be good to share what we learned and how it may affect MainLine West and our clients. The topics to be discussed can be categorized as follows:

- Muni Market Participants Health Report
- Muni Technology
- Fund VIII and Muni Hedge Fund Industry

Muni Market Participants Health Report

The players in the muni market appear to be changing. Some firms are "redefining" their role, some adding to their presence, and others fine-tuning their operations. **Firms cutting back or "redefining" their roles are as follows:**

Goldman Sachs - A top ten participant is going from a 20+ salesforce to 4. The new director of munis was hired six months from a hedge fund and they appear to be refocusing on a cross asset model and exclusive client lists. MainLine believes Goldman will most likely not be a top ten muni participant going forward, but will still be a provider for large high-profile deals.

Citigroup – A top three participant is going from 20+ salespersons to 7. Their focus will be to provide the same amount of product but use electronic trading platforms and focus more on "relationship business". MainLine believes Citigroup will most likely fall out of the top five over time and possibly lower. Citi has always been a long-time partner of MainLine, and will still be important, but we may need to find other firms to provide new deals that Citi can no longer support.

Firms maintaining their presence in the market and looking to add talent when it works: Wells Fargo, Bank of America/Merrill Lynch, Morgan Stanley, JP Morgan and Barclays. MainLine has deep rooted relationships with all of these firms, except JP Morgan which needed to be addressed on this trip. We anticipate all of the banks to remain important partners to MainLine.

Firms hiring and committing more capital and resources to the muni market:

Jefferies LLC – Once a bottom 20 participant is now in the top 10 and moving to the top 5. They continue to grow aggressively by adding salespeople, analysts, bankers, and underwriters. Jefferies could become MainLine's new "Citibank".

Stifel Nicholas & Co – Visited our offices recently. Once a top 20 participant, is now in the top 10 and growing. Stifel has grown through acquiring smaller regional firms and continues to look to grow their presence, while MainLine continues to grow its business with Stifel.

UBS – Has had an on again, off again relationship with the muni market that is now back on as they are hiring some of the muni veterans that other firms are letting go. UBS is focusing on the healthcare and housing sectors and providing a platform to trade bonds for small financial advisors. MainLine will be looking to increase its business with UBS going forward.

Sumridge Partners – A newer firm in Jersey City started by two experienced muni veterans has been a noticeable participant in the secondary market. Sumridge is looking to get more involved in the primary market and MainLine anticipates they will continue to grow in presence and as a partner.

What does this mean to the muni market, MainLine and our clients?

MainLine will be evolving, doing more business with new and upcoming firms, and will maintain a presence with all participants as our focus will remain on providing institutional access for our clients and Funds. *This means buying bonds directly from the underwriting and sales desk and not off of platforms, where offerings are restricted to that platform, and marked up on average 2%.*

Muni Technology:

Electronic trading remains a focus for the larger participants to get more business generated by providing different types of investors with different platforms. Major Banks are looking to save money and increase margins by using technology over actual people. They have also cut balance sheet exposure (dealer inventory) to a third of what it use to be over recent years, further showing less commitment to munis.

Algorithm trading is growing, and more firms are utilizing them. These are computer trading models focused on par amounts of less than $500,000, one year or longer in maturity, that have a predefined set of instructions on what price to buy and sell. They connect well with the electronic platforms and provide smaller sellers and buyers with easy access to the market but come at a cost to the investor. *They take advantage of individuals and advisors who do not understand the bond's true value, current market, or uniqueness of the offering.* Muni bonds trade at various spreads to each other due to credit risk, sector risk, in state demand, duration risk, and expected call date. These models try to "commoditize" the muni offerings by putting them in a "box", marking them up so the big banks meet their profit margins.

What does this mean?

Increased electronic platforms and computer trading models? A reshuffling of the largest participants, and lower balance sheet exposure? *All of this creates a more fragmented "sell-side" and combining this with the recent increase in buy-side concentration (four firms receive over 50% of muni fund flows) an increase in volatility will only continue.* What does this mean for MainLine clients? We see this as an opportunity, and not as a concern. Muni investors will need to be more knowledgeable on how to navigate the market, timing and where to source good value new bonds and sell old ones.

Fund VIII Bank/Liquidity Provider:

The **muni hedge market** (Tender Option Bonds) is down roughly 5% to 10% year-to-date, as volatility and economics have decreased the number of participants. Banks appear willing to provide liquidity and would like to build their book for the right client(s).

Once again, Fund VIII will have Barclays act as the leading provider. We plan to raise capital in the fall. The financing terms, resources, and our relationship with Barclays makes them an easy number one provider for Fund VIII. MainLine will look to negotiate two more agreements. *In our visits, Wells Fargo, UBS, JP Morgan, and Morgan Stanley all expressed interest in partnering with the MainLine Family of Funds.* Our funds are much different than other hedge funds that banks offer financing for. This makes us interesting to the banks, but also requires the bank to step outside its normal process and put some new ones in place.

What does the mean to you and MainLine West?

MainLine has established itself as a leader in muni arbitrage and hybrid TOB strategies. The sponsoring of Fund VIII is fully supported by our banking partners and MainLine will begin moving in the fall for commitments, and we hope for your continued support.